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Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

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South Korea: Foreign Investment Liberalization [redacted] 25X1

Summary

Seoul has crafted new measures to liberalize foreign investment in order to attract advanced technology from abroad and reduce reliance on foreign borrowing. The revised rules, which took effect 1 July, open numerous new areas for foreign investment and reduce red tape in the approval process. Foreign investors should find increased opportunities, particularly in the electronics, machinery, and transportation industries, the areas where frictions between Washington and Seoul over investment issues have been most pronounced. But the actual impact on investment inflows will depend heavily on how working-level bureaucrats implement the laws. [redacted] 25X1

The Liberalized Foreign Investment Policy

Revisions to the Foreign Capital Inducement Law (FCIL)--which has governed foreign investment since 1962--eliminate most barriers to direct foreign investment by:

-- Scrapping a system that listed only certain industries as open to foreign investment and precluded all others in

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This memorandum was prepared by [redacted] Korea Branch, Northeast Asia Division, Office of East Asian Analysis. Information available as of 21 August was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Korea Branch, Northeast Asia Division, OEA, [redacted] 25X1

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favor of a negative list system. Now, all industries are open to foreign investment other than those specifically proscribed by Seoul.

-- Replacing the requirement for prior approval for technology transfer with an after-the-fact notification system.

-- Increasing the overall share of industrial sectors allowing foreign investment from 44 to 67 percent. 25X1

We believe that the new system of listing only those industries specifically closed to foreign investment should clarify heretofore murky guidelines and will permit investment in attractive, but previously restricted, areas. Seoul is placing a high priority on attracting investment in high-technology sectors, and many formerly restricted areas--such as magnetic storage media for computers, steam and gas turbines, and industrial robotics--are now open to foreign investment. This should help South Korea's climb up the technology ladder and sustain its export led growth. 25X1

According to US Embassy reporting, jockeying over the final version of the negative list continued until its release on 27 June. Changes from an earlier draft suggest to us that the influence of the officials favoring liberalization was strong: sectors attractive to foreign investors that will benefit from innovation and technological upgrading were removed from protection while less attractive sectors with limited opportunities for technology transfer were added.[1] 25X1

Manufacturing Sector Benefits

In the manufacturing sector--the primary beneficiary of technology transfers derived from foreign captial inflows--foreign majority ownership is now allowed in 84 percent of all industries compared to 15 percent previously, and restrictions on foreign equity shares that affected 52 percent of manufacturing industries have been abolished. The number of manufacturing areas in which foreign investment of any kind is prohibited, is reduced from 19 to 10 under the new law. In 22 of the 70 industries on the negative list, the actual proscription on foreign investment is limited to only a few of the many possible

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[1]Examples of the first are animal feeds, cosmetics, small arms, and drugs, and of the second, the manufacture of wall paper, retailing of kerosene, and some artistic pursuits. 25X1

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products within the standard industrial classification. For example, while the manufacture of biological products is on the negative list, only blood products are actually restricted. [redacted] 25X1

Almost half the industries closed to foreign investment are in agricultural processing, printing and wood products industries. These businesses are primarily small- and medium-sized and their continued protection reflects Seoul's dedication to this type of industry, as well as the political importance of the farm sector. [redacted] 25X1

The emerging automobile and truck manufacturing sectors are protected from wholly owned foreign competition but are allowed access to foreign technology and marketing power through joint ventures. The infant semiconductor and computer industries, while theoretically free to acquire badly needed foreign capital and technology, may not be allowed to import high-technology capital goods and processes when domestically derived substitutes are available. We believe that this will not be a major restraint until South Korea's research and development capabilities improve. The technology-intensive sector receiving the greatest protection is telecommunication equipment, primarily optical fibers, which relies on licensing agreements for advanced technology. [redacted] 25X1

Others remaining closed are publishing, printing, the distilling of rice wines, and the manufacture of tobacco products, explosives, and coal briquettes. No decision has been made on the production of chemical fertilizers, a major industry in South Korea. [redacted] 25X1

Bureaucratic Procedures Altered

In attempting to reduce bureaucratic roadblocks, Seoul has instituted automatic approval procedures for investments under $1 million if the venture exports 60 percent or more of its product and has majority Korean ownership. The foreign equity restriction is waived if the products are free of import restrictions and are subject to a basic tariff of 10 percent or less[2]. [redacted] 25X1

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[2]Based on statistics for recent years we estimate that less than 10 percent of the value of US investments will qualify for automatic approval due to the large scale nature and concentration in capital intensive manufacturing of these investments [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

Within the Economic Planning Board (EPB), a division has been established to coordinate foreign investment activities and eliminate delays and inconvenience. Authority to approve foreign investment continues to rest, however, with the Ministry of Finance (MOF). [redacted] 25X1

Implementing the New FCIL

The new rules reflect the conviction of many economic policymakers in Seoul that foreign investment will bolster long-term growth by introducing technology crucial for upgrading the electronics, shipbuilding, and machinery industries in particular. Planners have also argued that increased foreign investment will reduce foreign borrowing requirements. Even though Seoul maintains a strong credit rating among international creditors, the global debt problem has reduced its ability to expand foreign borrowing. [redacted] 25X1

These moves toward liberalization result, in part, from the growing influence of officials such as Finance Minister Kim Mahn Je, Deputy Prime Minister and head of the EPB Shin Byong Hyun, and Presidential Secretary General Kang Kyong Shik. They link foreign investment liberalization, as part of a broad program, to efforts to reduce government intervention in the economy and rely more on market forces. Moreover, they view liberalization of imports, financial markets, and foreign investment as steps necessary to help counter growing protectionist sentiments in South Korea's major trading partners such as Japan and the United States. Their success in winning the ear of President Chun Doo Hwan was reflected in the adoption of new import liberalization measures in early 1984 and in more recent moves to reform the banking sector. [redacted] 25X1

More conservative officials in the Ministry of Trade and Industry, as well as much of the business community have opposed liberalization, including those moves affecting investment.[3] Distaste for foreign investment runs deep in the working levels of the bureaucracy including the EPB and MOF, and career officials fear their careers will suffer if they appear to favor foreign interests. Strong nationalistic feelings cause many South Korean officials to view liberalization as increasing South Korea's dependency on foreign, particularly US, business interests. [redacted] 25X1

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The divisiveness of the liberalization issue may carry over into the management of direct foreign investment. With both the EPB and MOF assigned an oversight role, time-consuming conflicts and mixed signals to investors could result unless lines of responsibility are drawn more clearly in the months ahead. [redacted] 25X1
[redacted] 25X1

Outlook for Direct Foreign Investment

We believe that the new FCIL represents a significant liberalization of foreign capital regulation and should result in increased foreign equity inflows. Many of the criticisms lodged against Seoul's handling of foreign capital--in particular ambiguity associated with the system of listing only industries approved for investment and restrictions on the share of foreign ownership--have been addressed by the new regulations. For instance, removal of foreign equity restrictions should increase inflows of high technology investments by giving foreign firms control over their proprietary products and processes. Weak patent protection and lax Korean attitudes toward contractual and licensing agreements have hampered high technology inflows in the past. The new regulations should increase the placement of technologically advanced products and processes in industries such as transport equipment, chemicals, electronics, and semiconductors, areas in which the United States in particular excels. General Motors and Daewoo have just announced a $427 million auto-parts and export oriented automobile manufacturing venture. This will result in a $100 million direct investment by GM. IBM, meanwhile, is considering a joint venture with Hyundai to produce the IBM 5550 computer for the Korean domestic market and, perhaps, for intra-Asian export. The entry of these large US corporations will improve the technological base and should enhance the image of South Korea and encourage other companies to invest. [redacted] 25X1

South Korea will continue to face competition from the other Asian LDCs trying to attract investment from overseas, an area South Korea has lagged behind other newly industrialized nations in Asia (Table 1). The trend since 1980, however, has been more favorable for South Korea than for Singapore, Taiwan or Indonesia. This trend is likely to continue as implementation of new FCIL regulations further improve South Korea's ability to compete for high-technology investment from abroad. [redacted] 25X1

Although the new law also eliminates the automatic five-year tax holiday and subsequent three-year 50-percent tax reduction,

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this change should not have a major impact on foreign capital inflows.[4] Less than one-fifth of foreign investors considered the tax concessions to have been important in their decision to locate in Korea, according to an EPB study. Moreover, Seoul reserves discretion in granting tax concessions and we believe tax relief will be available to investments in priority areas. 25X1

As the 1986 Asian Games and the 1988 Olympics approach, increased investment in services, tourism and the food and beverage industries is likely, with Japanese and West European investors vying with US investment. 25X1

We believe a change in the political climate would pose the greatest threat to Seoul's ability to increase foreign investment inflows. Signs of political instability could quickly tarnish South Korea's image among investors even if economic conditions remained favorable. 25X1

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[4] Special tax treatment is reserved for projects that augment import substitution or export promotion; have a high technology component; or have large scale capital requirements.

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Table 1

Million US $

Selected Asian LDCs: Direct Foreign
Investment (Commitment Basis)
1978-83

	1978	1979	1980	1981	1982	1983
South Korea	147.5	113.4	141.0	145.3	187.8	267.8
Singapore	359.9	387.0	573.7	625.0	545.4	604.0
Taiwan	136.7	181.5	243.4	356.3	320.3	N/A
Indonesia[1]	405.2	318.6	346.6	379.0	449.9	246.9[2]

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N/A: Not Available

[1] Arrival basis and excludes investment in hydrocarbons, banking, and insurance.

[2] Estimated.

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Appendix A

Industries Closed to Foreign Investment by Inclusion on the Negative List

Of the 272 sectors now closed to foreign investment 82 have been designated as closed for the indefinite future. They include areas in which foreign investment is not practical or appropriate and sectors in which foreign investment is not likely to be welcome in the near term. [redacted] 25X1

The remaining 190 sectors are temporarily restricted and may be opened to foreign investment in the future or, in extraordinary circumstances, be reviewed on a case-by-case basis for foreign investment at any time. [redacted] 25X1

In publicly justifying this broader "restricted" category, Seoul has characterized the industries included as those which receive special government assistance (such as subsidies or support for basic research), generate pollution, depend heavily on energy and/or imported materials, encourage consumption of luxury goods, adversely affect the farm and fisheries sectors, involve simple personal and household services, or are infant industries for which protection is necessary for the near term. Seoul has announced that it will update the negative list every six months with the intention of reducing its size. [redacted] 25X1

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Appendix B

Foreign Investment in South Korea

Direct foreign investment grew from $141 million during 1980 to $267.8 million in 1983. Approvals of direct foreign investment in the first half of 1984 totaled $315 million, well ahead of the annual plan of $280 million. This growth reflects past liberalization of the FCIL, strong domestic economic health, and global economic circumstances. In spite of steady growth, investments during the last decade lagged behind planned levels each year until 1983. In terms of technology transfer, higher returns accrue to direct foreign investment than to borrowed capital. Through 1978, direct foreign investment--according to a study by the Korea Exchange Bank--contributed 18 percent of all new technologies introduced into South Korea. [redacted] 25X1

The United States has been the largest foreign investor in South Korea since 1979 except for 1983 when Japan was the leader.[5] On a cumulative basis, Japan is the largest investor in South Korea (49.5 percent) followed by the US (27.7 percent) (see chart). [redacted] 25X1

Japan and the United States have invested most heavily in manufacturing. US investors committed 84 percent of their total funds in this sector. The Japanese have invested the greatest absolute amount in manufacturing, but relatively less of their total (57 percent). [redacted] 25X1

Much of Japan's early investment in South Korea involved the relocation of industrial equipment for manufacturing activities that were no longer profitable at home. Japanese investors were initially attracted by South Korea's abundant, cheap labor, but with the standard of living rising rapidly, South Korea is losing its comparative advantage in sectors such as textiles and electrical devices. We believe, therefore, that Japanese investment in manufacturing has probably peaked. We anticipate that future investment will focus on the tourism and food and beverage sectors and that it will provide little in the way of technology transfer. Japan sees parallels between South Korea's economic development and its own and is reluctant to provide technology that could boomerang, resulting in competition in home and third-country markets. [redacted] 25X1

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[5] Over half of the 1983 total for Japan was concentrated in one project (a $94 million expansion of the Lotte Hotel). [redacted] 25X1

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US capital has been concentrated in chemicals, electronics, and automobiles. US investors have been motivated by a desire to participate in the growth of the domestic Korean market as well as export to third countries. 25X1

US investors have shown a strong preference for majority ownership. In 1982 and 1983 87 percent of all US investment was in projects with 50 percent or greater US ownership. This compares with 51 percent of direct investment from all other sources. One reason for this preference for majority ownership by US firms is to reduce risk by protecting proprietary processes and technologically advanced products from South Korea's weak patent and licensing laws. The liberalized investment environment will open about 380 new industrial categories to majority control by foreign interests, potentially increasing the transfer of US technology along with the flow of equity investment. 25X1

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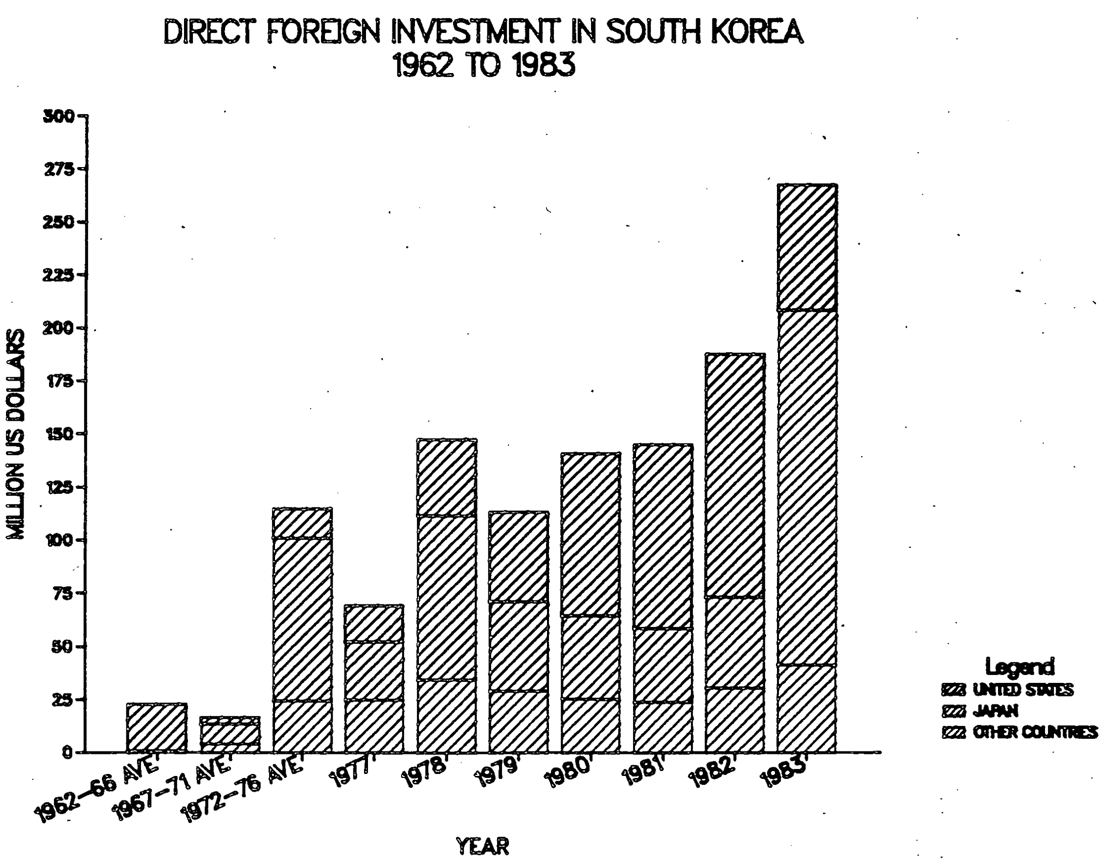
DIRECT FOREIGN INVESTMENT IN SOUTH KOREA
1962 TO 1983
MILLION US DOLLARS
300
275
250
225
200
175
150
125
100
75
50
25
0
1962-66 AVE
1967-71 AVE
1972-76 AVE
1977
1978
1979
1980
1981
1982
1983
YEAR
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UNITED STATES
JAPAN
OTHER COUNTRIES

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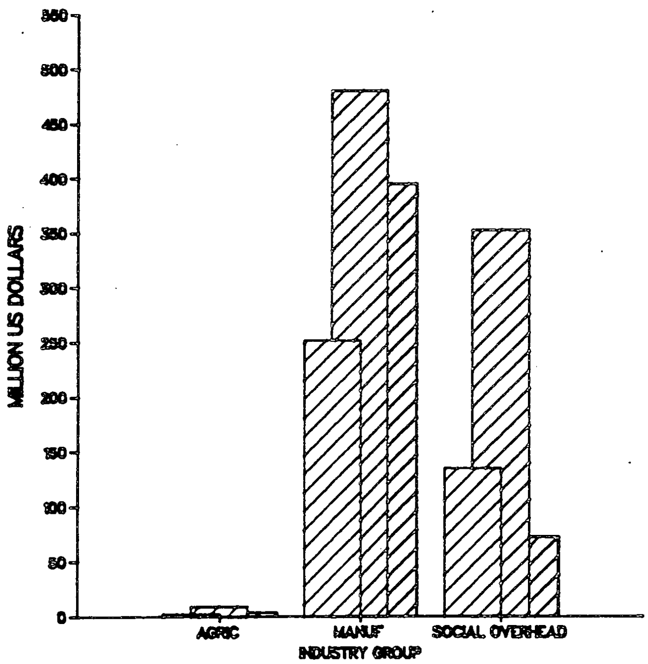
CUMULATIVE DIRECT FOREIGN INVESTMENT APPROVALS
BY INDUSTRY AND COUNTRY
1962 TO 1983



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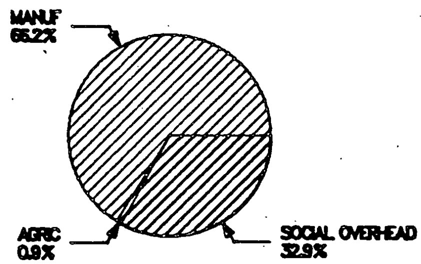
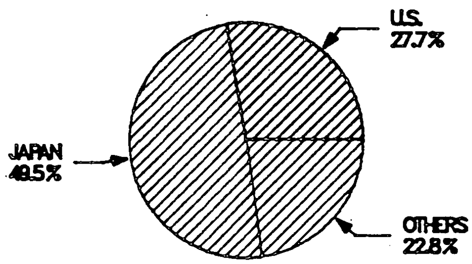
OTHERS
JAPAN
U.S.

CUMULATIVE DIRECT FOREIGN INVESTMENT
BY INDUSTRY GROUP



CUMULATIVE DIRECT FOREIGN INVESTMENT
BY COUNTRY OF ORIGIN



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